

BOLD BUSINESS SUCCESSION

Post-Connelly buy-sell agreement review guide

The creation of a buy-sell agreement is the most important step in the smooth transition of ownership of a company. It is especially critical with regard to estate planning.

A business buy-sell agreement states the time, place, price and pertinent details regarding the sale of a business either during life or at death. The buy-sell agreement can be a separate document or part of a more comprehensive owner's agreement.

The recent Supreme Court case, *Connelly v. United States*, 602 U.S. (2024), changed a clients' results regarding redemptions and company-owned life insurance to achieve the buy-out. The Supreme Court determined that life insurance death proceeds held by a company must be included in the value of that company with no offsetting liability for the redemption. Thus, **all existing buy-sell agreements should be reviewed to see if they are affected by Connelly.**

We've created materials to help you address this issue with your clients:

- An email template to alert them of the need to review their buy-sell agreement
- A client-focused white paper on the Connelly decision
- An agent-focused information sheet to help bring your team up to speed on the Connelly decision
- A post-Connelly business succession fact finder to help you gather information to help your client determine if a new buy-sell agreement is needed

You can find this information in the business succession section of our [BOLD microsite](#).

This manual will help guide you through the plethora of issues to consider in the development of a thorough buy-sell agreement, post-Connelly. However, it is not an exhaustive list and does not reduce the need to review these matters with competent legal and other advisors.

Initial considerations – parties to the agreement, agreement type, price, payment, triggering event, valuation, financing/funding

- The parties to the agreement must be identified as buyer and seller.
- The obligation to buy and sell must be mandatory.
- The price must be agreed upon by parties to the agreement.
- How the buy-sell agreement will be financed or funded and methods of payment (lump sum, installment sale, etc.) need to be agreed upon.

Determining the triggering events and how to value the business for each triggering event must be described, formulaically:

- Death
- Disability
- Divorce
- Long-term care
- Bankruptcy
- Retirement
- Cause

Buy-out price

How is the price to be determined upon the occurrence of a buy-out?

The price might be established by an appraisal, by an agreed formula or by an agreed value, which is set out in the buy-sell agreement and is reviewed and adjusted by the owners on a regular basis.

The IRS reviews prices in buy-sell agreements involving family members with special strict standards. As we saw in Connelly, in determining tax consequences, the IRS can ignore the buy-out price in a family business buy-out agreement unless the business can show that the price was determined in an “arms length” manner, which would have been agreed to by unrelated parties. With a fair market value purchase price, the variables to consider are both quantitative and qualitative:

QUANTITATIVE

- The revenues of the business
- The assets used to earn income
- The value of redundant assets
- The net earnings adjusted for owner/manager compensation and unusual items over a number of years
- The return of investment generated by the business
- Growth in earnings
- Gross margins and profit margins
- Debt
- Recurring cash flows
- Discounts negotiated with suppliers
- Rate of growth
- Insurance: Life, disability, long-term care (LTC)

QUALITATIVE

- Position in the marketplace
- Unrecorded assets such as contracts, patents, key customer relationships
- Unrecorded liabilities such as claims & contingencies against the business or warranties and guarantees extended to customers.
- Industry
- Competition
- Customer loyalty and goodwill
- Key employees
- Workforce
- Distribution channels
- Brand recognition
- Corporate alliances formed

Dispute resolution

If the owners get into a dispute, how can they resolve their differences without a long, expensive battle which could paralyze or destroy the business?

The agreement can provide specific binding procedures for resolving disputes quickly and economically through private arbitration, mediation or other alternative methods that are agreed to in advance by all owners.

Valuation method

A dollar value determined by a verifiable valuation method arbitrated by either a professional appraiser or other methodology must be articulated. Valuing a business on a multiple of adjusted average earnings or on the value of its assets adjusted for fair market value changes are generally methods used by professional evaluators. These methods are reasonable for use in the buy-sell agreement, depending on the nature of the company. Care should be taken in choosing a multiplier. It's best to seek the advice of a business evaluator in selecting a multiplier or in using these methods.

Independent, third-party buyers may also use the comparable business valuation method to value the business. This allows a comparison of comparable businesses and/or sale amounts of other entities. It may not, however, be the most appropriate method to have in a buy-sell agreement as it is difficult to obtain current relevant information that matches.

One practice is a "quick and dirty" method of determining what operating assets are worth at different levels of industry output. This may not be suitable for diversified businesses or one which holds assets not involved in operations. A program such as BizEquity[®]** can help the client understand that each industry typically has a set of generally accepted practices, whether formal or informal. Also, an agreement of the owners may be required to determine or amend the purchase price formula.

There are many factors that could make the purchase price formula obsolete. A mechanism should be in place for its periodic review and modification based on shareholder approval. Does modification of the purchase price formula require a simple majority, a specified percentage of votes, or unanimous shareholder approval? This requirement should be specified in writing in the buy-sell agreement. As we saw in Connelly, waiting until death to agree on an appraisal method is not advised.

Cross-purchase or redemption

Should the interest of the departing owner be purchased by the remaining owners (cross-purchase) or by the corporation, partnership or limited liability company itself (redemption)?

A buy-sell agreement may be structured in a flexible manner to allow either a cross-purchase or redemption. This "wait and see" approach allows the owners to evaluate the legal and tax consequences of either choice at the time a particular buy-out occurs. Be wary of this in light of Connelly. If a redemption is chosen, insurance proceeds owned by the business will be included in the business valuation. This means that the surviving owners should have an increase in value due to the inclusion of proceeds in the business valuation. Under a cross-purchase agreement, the proceeds may be excluded from the business, but a lower business value will be transacted.



Death of an owner

What happens if an owner dies?

The agreement should determine who will take over the deceased owner's interest. Is the deceased owner's interest in the business to be taken over by the beneficiaries of his or her estate, such as the spouse, children or other relatives? Or do the remaining owners of the business have the option or obligation to buy the deceased owner's interest from the estate of the deceased owner?

Life insurance funding

Is there life insurance in place to fund a buy-out in the event of death?

If so, each life insurance policy should have the proper owner and beneficiary designation to coordinate with the terms of the buy-sell agreement and to avoid adverse income and estate tax consequences.

Is the buy-out price to be paid in full immediately or paid in installments over time?

If payment is to be made in installments, such installment payments may be secured with additional collateral. Some types of security that are often required are stock pledges, security interests on the business assets, mortgages on real estate and personal guarantees. As we saw in Connelly, the life insurance proceeds held by the company will increase the value of the business.

Right of first refusal

If an owner wants to transfer his or her interest during such owner's lifetime, do the other owners have a right of first refusal to buy that interest before it is sold to a third party not presently involved in the business?

Existing owners of a business do not want to find themselves in partnership with a new individual whom they have not approved of; however, this may occur without a buy-sell agreement in place. As we saw in Connelly, when a right of first refusal exists, the choice can have consequences for the remaining business owners. They are in a position where the value of the business increased due to the insurance proceeds being included in the value of the business, yet they do not have funds sufficient to affect the buy-out at that price. If structured as a cross-purchase, the insurance proceeds would not be included in the value of the business.



Permanent disability of an owner

What happens if an owner becomes permanently disabled?

If disability is the triggering event, a clear, verifiable definition of disability, often coordinated with the definition used in a disability insurance policy purchased to fund the buy-out, may be advisable.

The disabled owner may no longer be able to contribute to the business. The other owners may want to purchase his or her interest. The other owners may need a source of liquidity to purchase the disabled business owner's interest. Additional capital or specialty insurance may be required to replace lost cash flows, or to train or hire a replacement if the disabled owner was key to the business.

How is permanent disability to be determined? Do the other owners have the option or obligation to purchase the disabled owner's interest, or will the disabled owner continue to own the interest despite the fact the disabled owner cannot work in the business?

Employment

Does an individual need to be employed by the business to be an owner of the business? Here are some questions your client(s) should consider as they review their buy-sell agreement:

- What happens if an owner who is an employee voluntarily terminates his or her own employment?
- What happens if the company terminates such owner's employment?
- Does it make a difference if the company terminates such owner's employment with cause or without cause?
- Do the other owners have the option or obligation to purchase the terminated employee's ownership interest, or will the departing employee continue to own his or her interest in the business?

Creditor protection/bankruptcy or insolvency of owner

If an owner's interest is attached to a creditor, or if that owner files for bankruptcy, do the other owners have the option to buy out the owner with creditor problems to prevent such owner's interest from being transferred to the creditor?

Will creditors (the new owners) have the right to seize or otherwise encumber the interests of an owner in the event of the owner's insolvency?

If so, the creditor becomes the owner and is afforded all the same rights. The creditors may be entitled to sell the shares in the open market without prior approval of the other owners unless stated otherwise. The creditors may force a liquidating dividend to satisfy claims. Other owners may be powerless to prevent liquidation.

Divorce of an owner

If an owner's interest is about to be distributed to the owner's spouse as part of a divorce proceeding, do the other owners have the right to buy such interest to prevent the interest from being transferred to the spouse?

If divorce is a triggering event, it will need to be defined in the agreement.

The business interest is an asset that may be subject to division of property under state matrimonial law. The owner may be required to provide an amount equal to a portion of his or her business interest or even of the actual business interest itself to his or her former spouse. The former spouse is either an owner or a significant debt upon the owners because of the division of assets. In either case, the expectations of this owner or former spouse with respect to distributions or other business policies may no longer align with those of the other owners. Provisions should be added to the buy-sell agreement to give the remaining owners the entitlement to buy out the divorcing owner and/or that owner's spouse, should interests in the business be awarded to that person.

To provide additional protection for the business in the event of an owner's divorce, a buy-sell agreement might also include a provision requiring unmarried owners to enter into a pre-nuptial agreement before getting married.



We're here to help

In this guide, we've provided guidance to some of the most common concerns of buy-sell agreements. However, business continuation is a vast and complex issue.

Be sure to take advantage of the resources provided in the business succession section of our BOLD microsite or contact Securian Financial's Advanced Sales Team:

1-888-413-7860, option 3

[Email the team](#)

[Meet the team](#)

www.securian.com/bold

Please keep in mind that the primary reason to purchase a life insurance product is the death benefit.

Life insurance products contain charges, such as Cost of Insurance Charge, Cash Extra Charge, and Additional Agreements Charge (which we refer to as mortality charges), and Premium Charge, Monthly Policy Charge, Policy Issue Charge, Transaction Charge, Index Segment Charge, and Surrender Charge (which we refer to as expense charges). These charges may increase over time, and these policies may contain restrictions, such as surrender periods. Policyholders could lose money in these products.

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